Nos. 20375, 20382

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

W. THOMAS DAVIS and ELIZABETH LLOYD DAVIS, M. PHILIP DAVIS and CAROLYN L. DAVIS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Review of the Decisions of the Tax Court of the United States.

REPLY BRIEF FOR THE PETITIONERS.

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TABLES OF AUTHORITIES CITED

Note: In order to condense our reply, we have not recited cases hereinafter referred to which were cited in our original brief; but rather have referred to the page of the original brief where the citation appears. Hence, the above table includes only authorities cited for the first time in this reply brief. We note, however, that the table in the original brief omitted reference to O. D. 714, 3 C.B. 49, which appears on pages 24 and 25 of the original brief.

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Our reading of respondent's brief leaves the impression of a collection of random thoughts half-heartedly advanced in support of a doubtful cause. This is understandable in view of the fact that respondent is now in an inconsistent position. In attempting to support the Tax Court's proration of price between the lemon crop and the orchard, respondent is reversing the Revenue Agent's report and deficiency notice which gave first allocation of price to the crop along with other current assets; and contravening his own continued first allocation of price to the other current assets, some of which were converted to cash after the crop was. [See discussion,

Pet. Br. pp. 8-12, Tax Court's comments, R. 47.] Respondent's brief attempts no justification of this inconsistency.

Respondent stresses the annual accounting concept of income taxation (Resp. Br. pp. 12, 14, 20) but that does not go to the issue here. If that concept required a determination of taxable gain or loss whenever any realization occurred, then the receipt of cash or cash equivalents from a purchased bundle of assets would result in gain or loss; which is concededly not so. (Resp. Br. pp. 15-18.)

Respondent says (Resp. Br. p. 16) that because Del Norte corporation would have had to pay income tax had it sold the crop, "the Del Norte shareholders would not expect to receive and taxpayers would certainly not pay them $237,700 with respect to the lemon crop," a *non sequitur*. The record here does not show whether Del Norte corporation's 1953 deductions would have exceeded its income if it had sold the crop. But Del Norte corporation did not sell the crop, and it realized no taxable gain from the liquidating distribution following sale by the stockholders of their stock. *Com. v. South Lake Farms, Inc.*, 324 F. 2d 837, 64-1, U.S.T.C. 9101 (C.A. 9, 1964), aff'g 36 T.C. 1027. Indeed a liquidating corporation, itself, may make a tax-free sale of its assets including inventory. Internal Revenue Code, Section 337. In any event, the purchasers' allocation of price among acquired assets cannot logically depend upon the tax liability of the sellers or their corporation.

The question whether taxpayers were paying the $237,700 to the Del Norte shareholders "with respect to the lemon crop," was immaterial to the selling shareholders, but vital to the taxpayer-purchasers. They

needed the $237,700 to conclude the deal; did not exercise their option until after the money for the presold crop was in escrow. [R. pp. 31, 38.] Had that amount of cash been in the corporate till, the buyers clearly would have paid an equal amount of the price for it. The same conclusion follows where the buyers finalized their purchase commitment only after completing arrangements to have the cash in the till at point of purchase.

The Revenue Agent's report and deficiency notice in this case followed O. D. 714, 3 C.B. 49, which for the past 46 years has treated value as the basis of a growing crop bought with the land, *i.e.*, given the crop first price allocation. Respondent's reinterpretation and repudiation of this venerable ruling (Resp. Br. pp. 19-20) are surprising.[1]

The ruling speaks in plain terms of basis equal to "the fair market value" of the crop "at the time of purchase." There is no justification at this late date for interpolating the foolish words "assum[ing] that there is no showing that the price paid for the land and the crop was less than their fair market values," as respondent would have us do. (Resp. Br. pp. 19-20.) We say "foolish words" because the ruling obviously contemplates an arms-length sale and purchase, in which the price paid represents the fair market values of land and crop. Had the Revenue Service intended to deny the application of this ruling because of opinion evidence that land value was more or less than purchase price minus crop value, the books would be full of cases litigating this issue. Compare *Herbert* (Pet. Br. p. 27)

[1]It is doubtful that the Revenue Service would concur with the Department of Justice in so doing.

where the Commissioner conceded and the Court allowed first allocation of price to crop, and *McGregor* (Pet. Br. p. 27) where the Commissioner persuaded the Court to accept such first allocation in order to deny the purchasing farmer a deductible loss from the crop sale.

Obviously there would be serious concern in the farming community if O. D. 714 were now invalidated. The business community also would be seriously concerned if the Revenue Service were now to repudiate or this Court to reverse the rule that in a purchase of current and fixed assets of a going business, the current assets are entitled to first price allocation. Long standing adherence of the Service to this principle is amply demonstrated by the Commissioner's agreement with it in the cases cited at Petitioners' Brief, pages 26-27 as well as his acquiescence in *Apex Brewing Co.* (Pet. Br. p. 27), 1940-1 C.B. 1, and his resistance to claimed loss in *McGregor* (Pet. Br. p. 27). Even in *F & D Rentals, Inc.* (Pet. Br. p. 28) receivables and prepaid items were given prior allocation with the Commissioner's consent.

Respondent does not comment (see Resp. Br. pp. 13-20) upon our point that there is no disharmony between the foregoing cases and *Blum, Symington* and *Graves.* (Pet. Br. pp. 28-29.)[2] Each of the latter cases involved

[2] *The Bessemer Limestone and Cement Company* (Pet. Br. p. 30) decided that assets acquired by a corporation through insolvency reorganization should have a basis equal to the security holders' cost rather than the lower fair market value of the assets. The actual allocation was made under Rule 50; it is unlikely that it resulted in increasing the basis of current assets over book value, but this cannot be determined from the opinion. Respondent's evaluation of the case (Resp. Br. pp. 17-18) is inaccurate.

a bundle of homogeneous assets to be disposed of in a comparatively short period of time, so that none of the assets deserved preferential price allocation. In *Blum* they were current assets of a partnership; in *Symington* they were securities and receivables segregated for liquidation; in *Graves* they were the assets of a terminated business purchased for liquidation. These situations are economically distinct from one where a purchaser, like the Davis brothers, buys a mixed group of assets for the purpose of indefinitely continuing the business operation with the fixed assets.

We do not believe that this Court will be inclined to reverse the long standing rule of O. D. 714 or of first allocation of price to current assets purchased with fixed assets of a going business; but even if it did, respondent's case is doomed. He concedes (Resp. Br. pp. 15-18) that a cash equivalent is entitled to first price allocation, but his reason for distinguishing the Del Norte lemon crop from a cash equivalent (Del Norte corporation's tax liability) is fallacious.

Necessarily cash equivalents must be determined at the point of purchase. Prior to the purchase, and prior to exercise of their option which bound them to make it, taxpayers had devoted speculative efforts to financing and completing the purchase, including the conversion of the crop to cash. By the time of the exercise of the option and the making of the purchase, however, the conversion was complete; cash for the crop was in the bank escrow. Hence, the crop was more like cash than

the cash equivalents discussed in the cited cases, for example, than the insurance and receivables in *Graves* (Pet. Br. p. 29) which required post-purchase acts of the purchaser for conversion to cash.

Respectfully submitted,

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Counsel for Petitioners.

June, 1966.

Certificate.

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

ARTHUR A. ARMSTRONG